Testimony of Aldo Caliari, Center of Concern
Before the Committee on Financial Services
U.S. House of Representatives on
"H.R. 2634, Jubilee Act for Responsible Lending and Expanded Debt Cancellation of 2007"

November 8, 2007

Thank you, Mr. Chairman. It is an honor for me to have the opportunity to testify today before this Committee.

Jubilee USA has consistently promoted the cancellation of debt in impoverished countries out of the firm belief that debt cancellation can free resources currently spent in servicing debt, for productive and social spending that are desperately required in those countries. The unfinished agenda on debt, that the Jubilee Act addresses, involves an expansion of debt cancellation.

But we are also aware that if we want to make this, as well as the recent and ongoing round of debt cancellation, have lasting effects, we also need to look at the way ahead. We need to ensure that the conditions of excessive debt that created the problem in the first place are not soon recreated. That is why provisions in the bill to ensure responsible lending/ borrowing, are an inseparable part of the package that we believe constitutes this unfinished agenda on debt.

Debt cancellation will undoubtedly open new opportunities for the reduction of poverty in indebted countries. We have seen already that it does, we have examples of it. However, if after debt cancellation, debtor countries engage again in excessive borrowing, we would soon be back in a situation where social and productive spending is curtailed and hindered by large amounts of debt service. Jubilee is also concerned about ensuring that the affected population has a say in the process of public debt generation. In the past, too many debts were taken on via mechanisms that were non-transparent, non-accountable and, ultimately, of little benefit to the population in the indebted country. Wiping the debt slate clean offers the opportunity for a fresh start, and a change. And this change needs to happen.

The erosion of the debt relief gains

Today the gains a number of low-income countries expected to achieve through recent debt cancellation are starting to be eroded. There are two main concerns I want to raise in this regard.

The first concern is that the debt levels of countries benefiting from debt cancellation are rapidly rising again, because of new borrowing on non-concessional basis. This concern has been underscored by the Group of 8 and the international financial institutions (the World Bank and International Monetary Fund, hereinafter "the BWIs"). Creditors that may not have participated in debt cancellation may actually take advantage of the newly attractive debt profile of countries receiving debt cancellation for providing financing on a non-concessional basis. The situation in which "*non-concessional lenders indirectly obtain financial gain from International Development Association ("IDA")'s debt forgiveness, grants and concessional financing activities without paying* *for it"(*IMF/World Bank 2006) is what in the jargon of the International Development Association has been called "free-riding."[1]

Rising levels of debt are not a phenomenon unique to countries receiving debt cancellation under the Multilateral Debt Reduction Initiative ("MDRI") in 2005. While this risk would tend to be smaller for countries that have lower access to capital markets, not all highly-indebted countries are excluded from access, especially if they are resource-rich countries that can collateralize debt with future export receipts. For example, in 2004 about 27 percent of the debt of 39 IDA-only countries classified as presenting a high or moderate risk of debt distress was non-concessional and only five of these countries[2] accounted for 78 percent of the stock of non-concessional debt.

But free-riding risks are especially significant for MDRI beneficiaries and countries receiving debt cancellation because their lower debt ratios put them back in a position where they represent an attractive debt profile. Post-MDRI, debt stock ratios in most recipient countries will be significantly lower than for many middle-income countries that primarily borrow on non-concessional terms, as reported by the World Bank. (IDA 2006: para. 15). In this situation, creditors that may not have participated in the debt relief effort may seek to profit by lending on a non-concessional basis.

Non-concessional financing for countries at risk has come from different sources, public and private. These sources include:

1) Emerging bilateral creditors (that is, non-Paris Club bilateral creditors) have increased their lending to LICs steadily. The six largest emerging creditors, by amounts, are China, Brazil, India, Korea, Kuwait and Saudi Arabia. According to US Treasury, this category of lenders represents the largest free-riding danger, as export promotion activities of these countries are expected to increase dramatically over the next several years. (US Treasury 2006:11)

2) Officially-supported OECD export credits: Provided by OECD governments through their export credit agencies.

3) Commercial credits and bonds: several Heavily Indebted Poor Countries ("HIPCs") have large commercial credits, such as Liberia, Sudan, Congo, and Cote D'Ivoire. It is also expected that many Low Income Countries (LICs) will, post-MDRI, be able to issue debt in private financial markets, a possibility that several of them are considering and that was, in general terms, closed to them because of their prevailing high levels of indebtedness. This is the case, for example, of Ghana, Kenya, Zambia. (Financial Times 2006) The IMF reports foreign investors' interest in debt of Cameroon, Malawi, Tanzania and Uganda. (IMF /World Bank 2006a:footnote 4)

4) Domestic loans: Many LICs are also resorting to issuing bonds in a domestic capital market, debt that is still not consistently addressed in debt sustainability analyses.

A second source of concern regarding the erosion of gains from debt relief is the activity of litigating creditors. One example of these that has recently come to the public attention, even though the problem has been around for some time, are so-called "vulture funds"-- creditors those who

[1] The definition conforms also to the one used by US Treasury in a recent paper , see US Department of the Treasury, 2006 ("Free-riders . . . indirectly obtain financial gain from international debt forgiveness and grant assistance – through improved country repayment prospects—without paying for it.")
[2] Sudan, Angola, Republic o Congo, DRC, Cote d'Ivoire.

profit by buying cheap sovereign debt in secondary markets and then maximize recovery via litigation and other pressure mechanisms.

The action of these entities has recently been on the news due to the case of Zambia and Donegal, a “vulture fund.” Donegal bought Zambian debt with a face value of $15 million for $ 3.28 million—Zambia had just reached agreement with Romania, the original creditor, for a settlement in that amount-- , and then sued Zambia before a British court for around $55 million. The British court, in the end, awarded Donegal $ 15 million, nearly five times what it bought the debt for.

However, “vulture funds” are not the only litigating creditors. Lawsuits have reportedly been the typical response from a substantial minority –or some times majority—of creditors to publicly-funded debt relief operations. In fact, litigating creditors also include commercial banks and other suppliers that refuse to participate in IDA commercial debt-buy back operations, as well as non-OECD governments also refusing to participate in debt relief operations such as the HIPC Initiative.

According to the latest World Bank survey, 24 HIPC countries have been targeted with lawsuits by a number of 46 litigating creditors. Eight of these have taken place within the last year. This is evidence of a growing tendency. In particular, the proliferation of vulture funds lawsuits against HIPC-beneficiary countries such as Congo, Zambia and Cameroon in the period 2004-2006, can be taken as a sign that it is with the latest round of debt cancellation that the business has become more profitable and attractive to these entities.

Some other relevant facts about litigating creditors are:

- Out of 46 plaintiffs, twenty six judgments have been awarded in favor of plaintiffs, amounting to US$ 2 billion (for claims originally valued in US$ 427 million). (IDA 2007:8)
- The total amount of debt covered by lawsuits is US$ 1.99 billion. This represents a rather small portion of HIPC debt, but over a 10 percent of the debt those countries would have after the latest round of debt cancellation goes through. According to estimates of the BWIs, total litigated debts are around 13-15 % of GDP in some cases.
- What matters is not only the amount of debt covered, as usually awards that find in favor of the plaintiff condemn the HIPC country to pay the original amounts plus interest and fees accrued on the debt while it has been in arrears and legal costs of the plaintiff.
- Awarded judgments may mean greater difficulties in terms of liquidity. For instance, Uganda and Sierra Leone faced lawsuit payments to creditors as high as 35 % of debt service in one year.

The prominence of the issue in the international agenda was in evidence at different G8 Finance Ministers meetings this year. At the last meeting, in Washington DC, Ministers expressed: “We remain concerned about the problem of aggressive litigation against HIPC countries. We welcome the steps already taken by the Paris Club to address this problem, urge all sovereign creditors not to on-sell claims on HIPCs, and are examining additional steps that might be taken.” (G7 Finance Ministers 2007). Britain’s Chancellor Gordon Brown has been among the leaders that pledged to take action to curb the behavior of “vulture funds.”

The Debt Sustainability Framework: a response to the rise of unsustainable debt ?

The problem posed by the possibility of high levels of new non-concessional borrowing that could undermine debt reduction is not a recent phenomenon. In fact, it was to address this problem that the World Bank and the IMF developed the Debt Sustainability Framework

Finally adopted by the World Bank and IMF in 2005, this framework had as a purpose to guide borrowing decisions of low-income countries in a way that matched their needs for funds with their prospective ability to service debt. (For a description of the Debt Sustainability Framework please see Annex 1.) As put by the World Bank, "with many 'graduated' HIPCs experiencing rising debt burdens again, and debt ratios in some other low-income countries also reaching elevated levels, there is a clear need for guidance on how much debt these countries can afford to accumulate." (IMF/World Bank 2004: para 8)

The emergence of the problem of free-riding described above attests to the flaws of the Debt Sustainability Framework (DSF) to achieve its otherwise laudable purpose. Still, the first response international financial institutions sought to give to the potential erosion of debt relief gains in recipient countries has come in the form of some additions to the DSF. On the one hand, they placed emphasis on fostering "creditor coordination" around the DSF, with the expectation that such coordination will grow out of mere outreach and communication efforts towards creditors not providing debt relief. (IDA 2006: IV.A) On the other hand, they placed measures that are expected to stop debtors from borrowing beyond sustainable levels. These measures come in the form of reduced nominal allocations to the affected borrowers and harder terms of assistance. (IDA 2006: para. 47) In the case of Fund-supported countries they are subject to conditionalities related to the level of borrowing. (IMF 2006: paras. 25/26; IDA 2006, para. 55).

There are a number of problems with this response. First, it should be acknowledged that some countries are going for non-concessional financing because of the absence of enough concessional funds to finance infrastructure and social spending required for development needs. The failure of donors to meet their aid commitments, which translated into less availability of concessional finance to meet development targets by borrowers, is, at least, one part of the reason why borrowers are getting re-indebted. It was clear that for the DSF approach to work a significant amount of grant funding would be required. While the DSF set thresholds for indebtedness, it did nothing to guarantee that grants would become available in the amount required by recipient countries.

The risks that in an environment of declining grants countries seeing their debt reduced might need to borrow again was clearly seen in advance by the creditors. In papers discussing the framework, the BWIs asserted

"Ultimately, the extent to which countries will face dilemmas between financing needs and long-term debt sustainability depends to a large extent on the international community's willingness to provide additional grants. Unless donors and creditors can significantly increase their pool of resources, a higher share of grant funding to some countries would have to come at the expense of reduced nominal transfers available to all. This would result in fierce competition for these resources" (IMF/World Bank 2004: 35).[3]

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[3] See also Ib.:32 ("The tailoring of new lending decisions to the risk of debt distress would almost certainly require an increase in the concessionality of financing to low-income countries and, consequently, a higher volume of grants, to avoid reductions in net transfers.")

It is well known that grant disbursements by OECD countries not only have not kept pace with the pledges at the Monterrey Conference in 2002, and Gleneagles in 2005, but have actually fallen by 1.8 percent in 2006, even excluding from the calculation, the admittedly inflating effects that one-off debt relief to Iraq and Nigeria had on the figures of the previous year.

Second, the problem with the scarcity of grants is compounded by the fact that the DSF itself may tend to overestimate the amount of debt countries can safely undertake. There are reasons to think that debt ceilings are still set too high, so the need for grants may be, if anything, underestimated. As I explain in going through the DSF (See Annex I) the third step of the DSF is meant to bring an element of conservatism into the debt sustainability assessment. An assessment of projected debt burdens in the face of plausible shocks is part of the measurement of debt sustainability under the DSF. At first sight, this provision seems to address one of the criticisms of the HIPC initiative, namely, its overoptimistic projections and lack of attention to external shocks. A closer analysis, though, reveals this is far from being the case.

The charge against HIPC in the past was that the very optimistic projections embedded in the DSAs underestimated the magnitude of the problems in debtor countries and, hence, debt relief needs. In the judgment of US Treasury staff, "it is unclear whether [the World Bank and IMF] have adequately addressed the problem of overoptimistic projections, which has been a leading cause of unsustainable MDB lending in the past." (US Treasury 2006:9). It goes on to quote the World Bank's independent evaluation estimates that the export projections used to determine the amount of debt relief provided under the HIPC Initiative have been significantly higher than actual historical export performance –twice the levels from 1990-2000 and almost six times those from 1980-2000." (Ib.) The concerns raised by analysts of the HIPC Initiative about the models used for integrating assumptions about export and GDP growth into debt burden projections[4] are not dispelled by a framework that continues to leave the exercise in the hands of the same actors and does not require any further disclosure from them. One problem underlined by a World Bank evaluation of 2003 is that "it is unclear how the initiative itself is incorporated into projections of imports and net resource transfers, or how the debt projections are integrated with the macroeconomic framework. It would be useful for the World Bank and IMF to provide an explicit

[4] The BWI assumptions about export growth and the consequent growth of GDP have been the subject of widespread criticism by many sources, generally for being too optimistic. (GAO 2000 and 2004; World Bank, 2003:28 and Annexes G and H) As early as 2000, the US General Accounting Office was pointing out that, even if export growth projections seemed to be consistent with the recent past, since the recipient countries were dependent on primary commodities these projections were subject to the vagaries of prices typical to those commodities. (GAO, 2000: 52)
The critique was eventually taken up by the staff of the BWIs itself. According to a HIPC Status of Implementation report dated September 2002, "Staffs' review of the export projections embodied in decision point documents suggests that earlier projections turned out to be optimistic in two-thirds of the countries reviewed . . .. It also confirms that projected future growth for decision point HIPCs was significantly higher than may be expected on the basis of past export performance alone." (IMF/World Bank, 2002: 28)
A more recent review by the US General Accounting Office of the 27 HIPCs that passed Decision Point found that projected export growth rates continued to be overly optimistic. GAO (2004, 15). While according to the IMF/World Bank the 27 HIPCs would become debt sustainable if they had an average export growth of 7.7 percent, "export earnings are more likely to grow", says the GAO, "at the historical annual average of 3.1 percent."
In addition to the accuracy of the assumptions, concerns raised by the Operations Evaluation Department of the World Bank relate to the models by which debt projections are conceived, the consistency with which they are applied and their sensitivity to selected assumptions. The Operations Evaluation Department claims in its report it was prevented from making a judgment on these matters because the methodological basis for these projections was not made available. Its concerns, it revealed, were strengthened by consultations with World Bank and IMF staff and analysis in the HIPC documents. (World Bank 2003:22).

statement of how the debt projections, including their balance of payments and fiscal components, are arrived at." The increased discretion DSF awarded to staff does not help.

In fact, last year I conducted a sample review of forty three DSAs, and found nine countries that, in their stress testing, had a breach of the respective threshold indicators and were, nonetheless, considered to be at a low risk of debt distress.[5] In addition, there were six cases in which the countries breaching thresholds were found to be at moderate risk. Given the continuation of an obscure and highly discretionary approach to reach conclusions from the performance of stress and vulnerability tests, it is very difficult to know what amounts for the difference in treatment between these countries and those where breaches of thresholds led to a determination of "high" risk. What I, perhaps more troublingly, found in this review, was that in fifteen cases[6], the policy-dependent threshold categorization that is supposed to act as point of departure for application of stress testing is not at all listed, making it impossible to know with any certainty where the final assessment comes from.[7]

Some positive results could have been expected from an approach that sought to safeguard against overoptimistic manipulation of models and data. But the lack of transparency and accountability in the implementation of these safeguards neutralizes these potentially positive aspects of the DSF.

Third, the approach is ineffective to deter unsustainable lending. Creditors, knowing that they are certain not to face any consequence for lending to borrowers above sustainable levels, have certainly no incentive to respect debt ceilings in countries whose reduced debt levels turn them into attractive profit-making opportunities. Given the lack of success of the HIPC initiative, which provided less debt reduction than the MDRI, to bring on board non-Paris Club creditors, public and private, there is no basis for the expectations that these same creditors will voluntarily give a positive response to the efforts around the DSF. If anything, given the greater amounts of debt forgiveness at stake, the incentives are exactly the opposite: more profit could be made by non-participating creditors that decide to "free-ride." IDA seems to be deeply aware of the futility of the attempt,

"Part of the complexity of the free-rider issue stems from the fact that there is no institutional framework either for a formal creditor coordination process or for the prevention of serious breaches of concessionality benchmarks by opportunistic commercial lenders. . . . A mechanism to ensure creditor coordination could lead to a superior outcome for all involved creditors. . . . The DSF . . . could not be expected to solve the free-riding problem associated with the provision of grants by IDA and other official creditors." (IDA 2006: paras. 34/35)

As a result, though responsibility for breaches to the debt ceilings is, at least, a shared one with the lending creditor, the effort would certainly leave off the hook non-participating creditors.

[5] The countries are Zambia, Vietnam, Sri Lanka, Papua New Guinea, Mozambique, Mali, Cape Verde, Armenia and Albania.
[6] Bangladesh, Bolivia, Bosnia, Cameroon, Comoros, Democratic Republic of Congo, Dominica, Grenada, Liberia, Pakistan, Republic of Congo, Rwanda, Sao Tome and Principe, Serbia and Zimbabwe.
[7] In six of these cases, the vulnerability assessment is also missing altogether (Bangladesh, Bolivia, Bosnia, Cameroon, DRC, Dominica).

Fourth, the approach, besides proving highly ineffective to stop unsustainable lending, might actually worsen the problem. The punishment inflicted on the debtor country is a reduction of access to IDA's concessional lending. Therefore, it is likely that the borrower in question, which evidently could not cover its needs of external financing resorting to concessional sources, will be forced to actually ramp up its appeal to non-concessional sources of financing. Again, this does also seem to be clear even in IDA's judgment, as expressed in the following warning:

"The key risk [involved with a volumes-based response to free-riding] is that affected countries may attempt to compensate for their reduced IDA allocations by seeking further non-concessional financing from other creditors." (IDA 2006: para. 55)

Finally, another of my colleagues at these hearings is dealing more in depth with conditionality, but it is fair to at least pinpoint here that the generation of a debt overhang had to do with lending that was not effective at promoting growth. Again, on the reasons for excessive multilateral lending, it is pertinent to quote the US Treasury paper:

"The incentive structure in the delivery of MDB assistance favored gross volumes. There were bureaucratic incentives to increase volumes, political incentives to approve large, visible transactions, and institutional incentives to ignore debt sustainability consequences since – until recently – MDB debt was not subject to reduction. . . . the IFIs filled financing gaps created by sudden declines in non-concessional, often speculative lending from commercial and official creditors, based their lending decisions on temporary commodity price increases and short-term growth prospects." (US Treasury 2006:4) The role that failed infrastructure projects and a dogmatic approach to macroeconomic policy conditionality have played in the lack of growth-creating lending is another reason why debt has gone up. But the need for a structural/ macroeconomic policy framework that ensures lending is applied to productive activities does not seem to be a concern of the DSF, which leaves untouched (and reinforces) the same macroeconomic/ structural orthodox conventions of the past.

Jubilee Act provisions addressing responsible lending

I believe that the measures contained in the Jubilee bill currently under your consideration will significantly improve over the current situation, and lead us to preventing the re-emergence of unsustainable and irresponsible debt levels in impoverished countries.

First, let me state the bill's provisions for a strengthened framework on transparency (Sec. 1626, b), represent a key contribution towards this goal, by ensuring a greater influence by affected communities on the undertaking of new loans.

But I want to focus on the provisions on Sec. 1626 (c), on a Framework for Responsible Lending, which we believe are at the center of the response. The proposed legislation contains a generic call on the Executive to "develop and promote policies to ensure all creditors, with no distinction, will contribute to preserving the gains of debt relief for low-income debtor countries." It can be appreciated that this is a very open language, and different measures may be envisioned to fulfill it.

But then the proposed legislation goes on to suggest some more concrete measures.

It calls for providing that "external financing needs of low income countries are met primarily through grant financing rather than new lending." As I have stated, a "pull" factor leading recipient countries to undertake new borrowing is the scarcity of grant financing. Increased grant finance has been promoted by the US Treasury, in IDA and bilaterally. Still, the level of grant financing envisioned in IDA did not rest on the notion of how much financing countries need, but on how much was the available financing the donors were willing to provide. We believe more could be done.

The bill also seeks the international adoption of a binding legal framework that

(A) guarantees that no creditor can take or expect to take financial advantage of acquired or newly awarded debt relief through the terms and rates of their new lending to beneficiary countries;
(B) is binding on all creditors, whether multilateral, bilateral or private;
(C) foresees, as a sanction for creditors who violate it, an equitable share in the burden of the losses from any future debt relief needed by the sovereign debtor to whom lending was irresponsibly provided;
(D) provides for decisions on irresponsible lending to be made by an entity independent from the creditors; and
(E) enables fair opportunities for the people of the affected country to be heard; "

We acknowledge this is not easy, and that it will take time. But we also believe, for the reasons expressed in my assessment of the existing response, that if we want to achieve a long-term solution to the debt problem, there is no way around this measure. Only a binding framework that applies to all creditors, public and private, can change the incentives intrinsic to the system today.

The existing measures that rely on punishing the debtor are, apparently, easier to implement, and maybe considered the low-hanging fruit. But they are also quite ineffective, not to mention unfair. The measure the bill proposes will set the incentives right for new lending and borrowing. The measure seeks to complement the measures that rely on borrowers' compliance with a sanction to the creditor that engages in irresponsible lending. Please note that the sanction comes simply in the form of an equitable share in the burden of losses from a debt write-off, <u>should a debt write-off become necessary in the future</u>. But the hope is that no new debt write-offs will be necessary because this is, first and above everything, a preventive measure. If creditors know that they are susceptible to taking a haircut in case lending proves to be irresponsible or unsustainable, they will have every incentive to respect non-concessional borrowing ceilings, unlike the system today where they have every incentive not to.

Obviously, one very easy objection to this call is that such a mechanism will not work unless every public creditor subscribes to it (one can presume private creditors are under the regulatory jurisdiction of some public authority, so their consent will not be necessary). This should not be an obstacle to start the process of seeking the adoption of such a framework. What is at stake here is a problem of collective action. Collective action solutions always start with a leader, or a champion.

With regards to the set of issues raised by vulture funds, the proposed legislation also contains specific additional measures by calling on the US Treasury to

"(2) collaborate with appropriate government agencies to prevent private investors from profiting from buying low-income country debts at market value and attempting to recover their original value or more (commonly known as `vulture funds'), including by—
(A) designing legal remedies to curtail or realign the incentives for this activity"
(B) identifying avenues to provide legal support to countries being sued by `vulture funds'; and

(C) providing technical assistance to advise possible targeted governments on measures to take to prevent `vulture funds' from successfully taking them to court;”

Let me say something about each of these measures:

A) Designing legal remedies to curtail or realign the incentives for this activity

Legislative action could certainly help realign the incentives for vulture funds to profit from the regained financial strength of debtor countries. Of course, success in the adoption of a legally binding framework on responsible lending would ensure any lawsuit by a creditor that has not taken an equitable share in the burden of the debt write-off, would have its lawsuit dismissed in courts, and this includes vulture funds.

But I refer you to other efforts that may yield fruit in the shorter term, as worth consideration. For example, the proposal by the Livingston Group that would make “sovereign debt profiteering” – the main activity in which “vulture funds” engage—illegal. Also, given that two thirds of litigation has taken place in US and UK courts, chances are that national pronouncements via legislation in these two countries can change significantly court outcomes.

(B) Identifying avenues to provide legal support to countries being sued by `vulture funds';

The Commercial Debt Reduction Facility, administered by IDA, provides grant funding to enable HIPC governments to buy back outstanding commercial debt. Established in 1989, good part of the success in debt relief recipients to bail in the private sector creditors has been due to the catalytic factor of this facility in helping buybacks of debt. In total, DRF has supported 22 completed buy-back operations in 21 countries, extinguishing a total of about US$ 8 billion, utilizing about US$ 637 million. In the absence of, or until longer-term solutions, can be implemented, the DRF has shown its potential for efficient use of resources in deflecting the action of litigating creditors. It should be strengthened and its terms should be more flexible to allow assistance to low-income countries that, rather than a buyback, need to pay for the legal support required to face litigation (today a certain amount can be applied to legal and advisory fees to prepare the debt buy-back operation, but not specifically fend-off threats of litigation).

(C) Providing technical assistance to advise possible targeted governments on measures to take to prevent `vulture funds' from successfully taking them to court;

Finally, a lot more could be done by recipient countries themselves if they had the chance to count on proper advice and systematically follow it in dealing with private creditors, especially before the threat of litigation arises. The success in taking these measures usually boils down to knowledge and human resources, and technical assistance could help governments surmount those obstacles.

Conclusion

The Jubilee Act calls for completing the unfinished agenda on debt. In doing so, Jubilee is asking Congress to expand debt cancellation, but also to implement measures to ensure that, towards the future, new lending and borrowing will be carried out on a responsible basis.

Annex 1 - Debt relief frameworks: a brief synopsis

The Enhanced HIPC Initiative had as a goal turning the debt levels of 42 countries, representing 8% of total debt of developing countries, to a sustainable level.[8] Seen against this backdrop, the HIPC goals seem rather modest. Nonetheless, the HIPC Initiative represented the first attempt to deal with all debt (bilateral, multilateral and private) in a comprehensive manner, and it is the first one to include reduction of debt owed to multilaterals. HIPC consists of two stages. At first, the potentially eligible country builds a track record of implementing World Bank–IMF programs for three years. At that point, called the Decision Point, the BWIs determine whether, after all traditional debt reduction mechanisms have been tried, the country's debt would still be above a numerically pre-determined threshold. If this is the case, a package of debt relief is designed. In order to obtain full debt relief the country needs to continue a series of reforms for three or more years. When this is achieved, the country reaches what is called Completion Point and the promised debt stock is written off. Between Decision and Completion Point, however, debt service relief already happens on an interim basis. In total, when completed, the Initiative would provide up to two-thirds debt reduction to the eligible countries.

The Debt Sustainability Framework (DSF) was adopted by the IMF/World Bank as the new framework for managing the debt of Low Income Countries (LICs) early in 2005. The DSF applies only to LICs in account of the argument that Middle Income Countries' general capacity to access to capital markets militates in favor of different rules than those applicable to countries that are mostly dependent on official creditors. Among LICs, the DSF applies to those that have either never entered, or already graduated, from the HIPC Initiative. Countries in between would have both types of assessments carried out.

An important characteristic of the DSF is that, unlike the HIPC Initiative, it is not used as a basis to calculate debt relief. The policy consequence of lower debt thresholds under the HIPC Initiative was to flag the need for greater debt relief. Instead, the policy consequence of a lower debt threshold under the DSF is decreased access to lending in non-concessional terms and the need to finance remaining development and poverty reduction goals via grants, with the option of debt relief (or further debt relief, depending on the case) being ruled out.

Also unlike HIPC, the DSF does not rely on pre-set numerical indicators but rather on country-specific debt thresholds.

The establishment of thresholds is arrived at through a method based on three pillars. The definition of debt thresholds is dependent on the quality of policy of the indebted country, assessment of actual and projected debt burden indicators based both on baseline and stress test scenarios, and a comparison of the country's debt burden against these indicators, leading to an overall assessment of the country's risk of 'debt distress'. It is on this final conclusion that subsequent financing decisions are meant to be based.

[8] The figure is taken from World Bank, 2003, 5 and the goal from id.,11. More recent documents from the Bretton Woods Institutions have become increasingly cautious in describing the goal of the initiative. See e.g. IMF/IDA 2003, 5, "[The Enhanced HIPC Initiative] charted a course toward restoring debt sustainability by providing resources for substantial debt relief. However, the Initiative, ... can only support but not guarantee sustainability going forward."

Country-specific debt thresholds are generated on the basis of the quality of their policy and institutional environments, measured using the Country Policy and Institutional Assessment (CPIA) methodology. The CPIA system compares a country's institutional and policy framework against a set of pre-established criteria, receiving a score based on a standard, pre-set view of what is considered a good performance. Depending on their CPIA ratings, countries are placed into three groups (poor, medium and strong), and for each of the five fiscal measures used, assigned a threshold debt level range.

The second step in the DSF process is 'assessing and interpreting a country's current and prospective debt-burden indicators under [a] baseline [scenario] and in the event of plausible shocks.'[9] The baseline scenario centers on macroeconomic and fiscal forecasts about the conditions likely to confront the country over the next twenty years, according to the IMF, while the exogenous shock scenarios or stress tests are circumstances such as diminished GDP or export growth, or a depreciation in the value of the national currency, that the country subject to analysis may face.

Finally, these indicators are compared to the thresholds previously established, and on the basis of whether they are under or over the established limits, a rating of low, medium or high risk of debt distress is made. Taken literally, this framework would leave little room for discretion, but in fact a more nuanced approach is encouraged in reaching the ultimate conclusion, meaning, for example, that countries breaching one or more of the thresholds can theoretically be determined to still only be at low risk of debt distress.

Such a rating is then meant to inform the longer-term financing strategies of the IFIs and other lenders and donors as regards the level of the grant element in new financial flows to such countries. Those at a lower risk of debt distress and better prepared to handle the fall-out from external shocks are assumed to be able to take on higher levels of (concessional) financing, while for countries with high levels of debt distress, an increase in the amount of funding received as grants is deemed preferable. Concretely, a "traffic light" system has been established. Countries at a low risk of debt distress receive a "green light" (so are able to finance their requirements through loans). Those at a medium risk of debt distress receive a "yellow light" (can be financed through a 50-50 mix of grants and loans). Those at a high risk of debt distress can only be financed through grants ("red light"). Debt, in this framework, is supposed to be brought under the country's allowed threshold through the persistence, over time, of a particular level of grants and loans to fulfill financing requirements.

[9] IMF/IDA 2004, 24

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